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TAGS: EFIN ECON PREL PL
SUBJECT: Markets Show Increasing Appreciation for the Polish Zloty's Strength

Ref: 2004 Warsaw 386

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¶1. (SBU) Summary: The Zloty appreciated the most of any convertible currency against the Dollar, growing 20% in ¶2004. Most observers attribute this rise to a mix of factors, including greater political stability under the current technocratic government, Poland's entry into the EU in May, and the relatively high interest rate offered on Polish government bonds. The Polish Government and financial markets are still trying to assess whether the Zloty's rise reflects a long-term shift in fundamental economic conditions, or whether it is a short-term phenomenon related to Poland's EU accession. Most analysts believe it is the former, and expect the Zloty will appreciate further in 2005. Although the Government would prefer to continue to let markets set the exchange rate, it will be forced to begin taking a stand on what the Zloty's `real' value is as part of its preparations to enter the ERM II in 2007 on the way to adopting the Euro by 2009. Pressure for the Government to intervene to lower the Zloty's value to help exporters has been muted until now, as exports have continued to grow. Additional appreciation may increase calls from exporters for some relief, particularly given that 2005 is an election year. End Summary

The Zloty a Highly Appreciated Currency
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¶2. (U) Despite a rough start, 2004 proved to be a banner year for the Polish Zloty (which means golden in Polish). The Zloty appreciated more than any other convertible currency against the dollar, gaining 20.14%, outpacing other Central European currencies by a comfortable margin (including the Hungarian Forint at 13.9%, the Slovak Koruna at 13% and the Czech Koruna at 12.4%). By the end of the year, the dollar had fallen below three Zloty per dollar, the lowest level it has been in seven years. The Zloty appreciated more than 14% against the Euro. Private sector economists attributed the Zloty's rise to: the stabilization of the political scene after the appointment of Belka's technocratic government in July; improving economic fundamentals; Poland's entry into the EU on May 1; and the attractive carried interest rate on Polish Government bonds.

2004: A Very Good Year:
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¶3. (U) In terms of fundamentals, for the fourth year in a row, exports were up significantly, growing approximately 20% for the full year in 2004. This strong growth helped push the current account down to 1.8%. Exports helped push economic growth to an estimated 5.6% for the entire year. For the first time in three years, investment grew, by 4.1% through the first ten months (preliminary estimates suggest the full year's total could be up to 8%). Foreign Direct Investment remained relatively constant, at an estimated $6 billion, due in part to the revival of the government's privatization program.

¶4. (U) Poland's entry into the EU opened Polish investments to many foreign investors (e.g., pension funds) who would not have previously bought government bonds or shares. Coupled with the stabilization of the political scene since the installation of a technocratic government, many investors perceived an "established" country's level of political risk with an emerging market's level of return (one-year Polish Government bonds averaged close to 6.35% for the year, reflecting lower ratings by investment agencies compared to other Central European counterparts). As a result, Poland attracted $12.2 billion of portfolio investment, the highest level since 2000. This total includes $8.7 billion in foreign purchases of government bonds, more than three times the average level of 2001-3. This, combined with $680 million invested in Poland's stock

markets, helped strengthen the Zloty. The National Bank of Poland (Poland's Central Bank, NBP) does not believe that most of the portfolio investment increase is hot money, but is comprised primarily of more stable investors such as EU pension funds.

How Golden is the Zloty?

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¶5. (U) The question is whether the Zloty will remain as attractive in 2005. Government and private sector economists expect that investments will be the main driver for the 2005 economy. Capacity utilization rates are at historic highs, and more than eight quarters of strong export growth have delivered good profits to Polish companies, which are now sitting on very large corporate bank accounts. The one great unknown has been the composition of the new government that will take office after general elections later this year. As this situation becomes clearer, Polish companies are expected to begin investing, which in turn should sustain economic growth, forecast at 5.0%.

¶6. (U) The Polish Government anticipates completing several large privatizations in 2005. The GOP conservatively forecasts that it will earn 5.7 billion Zloty ($1.84 billion) from these sales, several of which are expected to attract foreign investors (including the state insurance company PZU, chemical and energy plants and industrial concerns). The Polish Government will also embark on a number of EU funded projects, particularly in the infrastructure sector, taking advantage of its first full year of EU membership. There should be significant inflows of EU money by the end of the year (up to 3 billion Euro).

Pressure on Exporters:
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¶7. (U) Polish exporters have begun to complain that the relentless appreciation is making their exports less competitive. Their complaints have been muted in part because a number of their inputs, including gasoline and, in some cases, bank loans, have been priced in dollars, meaning that their relative input costs were stable or declining while their revenues - measured either in Euro or Zloty - were appreciating. Polish exporters have also compensated by increasing productivity throughout 2004, which has enabled them to continue making good profits even at the cost of having to trim prices to compensate for the stronger Zloty. Productivity increases in 2004 outpaced appreciation against the Euro, although not against the dollar. Market economists have estimated publicly that exporters would begin to feel the pinch at around 4.25 Zloty per Euro (it was trading just over 4.10 during the last week of December). Bankers and companies tell us they remain confident about their ability to continue export growth, although further appreciation will pressure them to cut costs, including by freezing or cutting employment to lower labor costs. Polish importers report they have been hit harder by the dollar's fall, as some industries compete with Asian suppliers who price their goods in dollars.

Fundamental Shift or Short-Term Blip?
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¶8. (SBU) An NBP exchange rate expert recently explained the Bank's dilemma in determining whether the Zloty's appreciation represents a fundamental change in the real economy, or whether it represents a temporary shifting of prices following Poland's accession to the EU. NBP's inclination is that most of the Zloty's appreciation can be explained by a fundamental shift in the real economy rather than a short-term market, or speculative spike. NBP expects that the real effects of joining the EU will continue to build, potentially even doubling total trade with the EU as smaller companies develop the ability to participate in the broader EU market. This greater economic participation would justify a higher exchange rate.

¶9. (SBU) The expert noted that the sharp fall of the dollar (35% against the Euro in three years) has exaggerated some of the Zloty's movement. The Zloty has been more stable against the Euro in 2004, increasing 14%, versus 20% against the dollar. He explained that the dollar's sharp fall has accelerated a shift in the Zloty's foreign exchange "basket," (a rough benchmark used by the market to gauge whether the Zloty is under- or over-valued) away from the traditional 55% Euro pricing/45% dollar pricing to something closer to 70/30. The slower rise against the Euro has tended to shift greater volatility towards the dollar, compounded by currency arbitrage, typically betting against

the dollar.

¶10. (SBU) There is a real possibility, however, that the Zloty overshot in 2004, and that there could be some retreat, particularly if markets become more nervous about the effect of a new government after general elections later this year. A new government will have an important effect in determining tax rates, the pace of inflation through its control of fiscal policy, and indirectly, on the exchange rate. Many Polish companies will wait to invest until they have a better sense of which parties will form a new government, and what policies they will implement. As a result, 2005 is likely to see more volatility than 2004. Most analysts, however, expect fundamentals to take over again by the end of the third quarter, and the Zloty to appreciate by year end.

Interventions?
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¶11. (U) The question of whether and how the GOP should respond to the Zloty's appreciation has become a central question for policy makers. The Central Bank and Ministry of Finance have welcomed the effect appreciation has had in damping down inflation after accession to the EU in May. However, they are also getting more nervous that the Zloty is appreciating too rapidly. On November 30, a deputy NBP governor sparked a flurry of media attention by suggesting that Central Bank intervention in the exchange rate was technically possible under certain conditions. The next day, NBP Governor Balcerowicz said publicly that NBP's strategy of "not intervening" was working well, and suggested the Zloty had further room for appreciation. Markets did not react to the specific event, but have begun a broader discussion about the possibility of interventions.

¶12. (SBU) Market analysts tend to doubt that the Central Bank would intervene, noting that Poland has been steadfast in its adherence to free floating exchange rates. There have been no interventions since 1998. Central Bank officials also point out that it would be very hard to get the amount of intervention right, particularly in the current situation when the government statistical office is undergoing significant revamping of the way it collects basic data, including trade and investment. Without a better sense of events in the real economy, the Central Bank is unlikely to intervene on currency markets, which could risk setting off market reactions which would take much longer to stabilize than adjusting to the current appreciation.

¶13. (U) The Monetary Policy Council could respond by cutting its monetary policy bias, as an indication of the future direction of interest rates. Currently, it remains negative, signaling its determination to fight inflation. The MPC could decide, however, that it needs to cut interest rates to ease pressure on the Zloty. The MPC would prefer to have more data indicating that inflation really is on the way back down after the sharp spike after EU accession (prices increased from just under 2% inflation to 4.5%). Most analysts have interpreted public NBP and MPC comments as an attempt to signal a desire to ease monetary policy without cutting rates, sending a signal to potential speculators that they do not want to Zloty bid up artificially at the expense of exporters.

ERM-II
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¶14. (SBU) The question of getting the exchange rate right is a crucial question for the GOP to resolve as part of its obligation to adopt the Euro. Ministry of Finance and Central Bank officials will meet at the end of January to begin discussing policy towards entering the Exchange Rate Mechanism (ERM-II) required by the EU on the road to adopting the Euro. Once countries meet the Maastricht criteria, they can apply for ERM II membership, during which they must remain in compliance with these criteria to demonstrate stability before entering the Euro zone. NBP and Finance must jointly agree on a central exchange rate target to join ERM II, which in turn requires broad agreement on monetary and fiscal policy to keep inflation in check. The GOP would then negotiate with the EU to fix a central exchange rate for the ERM II. The GOP has already

set out its policy targets in the Convergence Strategy it submitted last fall to the European Central Bank. The challenge is for the current government to set Poland on a path to meet its Convergence targets and be ready to enter the ERM II in 2007 at an exchange rate which will sustain long-term growth. From comments made by EU counterparts, GOP officials have the impression that some of Poland's EU trading partners may try to pressure Poland to adopt a less competitive exchange rate to reduce competition from Polish companies.

¶15. (SBU) In informal talks with the ECB, GOP officials understand that it is virtually certain that Poland will be able to operate within the wide band of a central parity exchange rate while in the ERM II. Poland had been concerned in 2004 by EU member state comments implying that Poland could be required to maintain a narrow band (of 2.5%) around the parity, and that the EU would pay particular attention to any sharp depreciations. The dollar's continued sharp fall in 2004, particularly against the Zloty, would have made it exceedingly difficult to remain within that band, as three month volatility averages by the end of the year were still over 11%, compared to a more stable Euro range of 7.3%. NBP notes that Poland expects to meet the Maastricht criteria on budget deficit/GDP by a relatively narrow margin (2.7% compared to the limit of 3%), suggesting that adopting a narrow band would have little credibility.

Comment:
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¶16. (SBU) Perversely, the Zloty's appreciation is a byproduct in part of the political stability in 2004 which companies have long sought. The silver lining for exporters is that the elections this year may stem the Zloty's rise for a while, although most observers expect the Zloty will appreciate further based on solid economic fundamentals. So far, most of the discussion about the exchange rate has been held within technical or financial market circles. Continued appreciation of the Zloty will increase calls from exporters, however, for politicians to "do something," particularly given that 2005 is an election year. While the GOP would clearly prefer to let markets set the Zloty's exchange rate, it will have to take a policy stand on what the central parity exchange rate should be in order to meet its goal of entering the ERM II in 2007.

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